SOP 50-51 2

LOAN UNDERWRITING CRITERIA - RISK MANAGEMENT DATABASE

Appendix 16 -

1. **Section 102 of the Small Business Programs Improvement Act of 1996 Requirements.**
Section 102 of the Small Business Programs Improvement Act of 1996 requires SBA to report on the performance of its business loan portfolio utilizing a Risk Management Database. To comply with this requirement, SBA must compile statistical data on every business loan SBA makes or guarantees, and must calculate certain key ratios for entry into the database along with collateral information for every loan that goes into default (e.g., is transferred to liquidation). By assessing the underwriting characteristics of each loan at the time of application, SBA may gain significant insight into causes of default.

2. **Information to be collected.**
The information to be collected includes ratios showing the applicant's financial condition at the time of application, both on an actual and on a pro-forms basis and the net realizable value of collateral at the time of default (when a loan is placed in liquidation). Processing personnel must ensure that lenders know about the requirement to include the data with their liquidation plans on defaulted loans. SBA personnel will input the data for all loans transferred to liquidation.

The data to be collected include:
a. Credit history indicator at the time of origination;
b. Current ratio and debt to tangible net worth ratio at origination;
c. Collateral analysis showing loan to value ratio for both fair market and liquidation values; and,
d. The net realizable value of collateral at default.

3. Ratios and Miscellaneous.
To have a valid basis for comparison, the same methodology must be used by all offices to compute the ratios.

a. **Credit History Indicator (A, B, or C).**
Use "A" if the credit rating is acceptable based on the normal credit review process; use "B" if the firm's credit rating is marginal; and "C" if the company is a new business with no credit history.

b. **Current Ratio (CA/CL).**
The current ratio is calculated by dividing the current assets by the current liabilities. The current ratio is a commonly used measure of short run solvency, the ability of the firm to pay its debts as they come due. The current liabilities (accounts payable, notes payable, current maturities of long term debt, and accrued expenses) are used in the denominator because these are considered to be the most urgent debts, requiring payment within a year or an operating cycle. The available resources to satisfy these obligations must come primarily from cash or the conversion to cash of other current assets.

(1) The current ratio is a static measure based on the figures in the balance sheet at a particular date. It measures only the ability of current assets to meet current liabilities on that date. Usually, current assets are of a revolving nature since collected accounts receivables are replaced by new receivables, and the current liabilities are of a refunding nature—The repayment of one is followed by the creation of a another.

(2) For "Projected at Origination" include the effect of the pending financing on the ratio components.

c. **Debt to Tangible Net Worth (TL/TNW).**
(1) This ratio is calculated by dividing the total liabilities of the firm by the tangible net worth. It represents the proportion of the assets provided by creditors and the portion provided by owners. The debt to equity ratio measures the level of risk of the firm's capital structure in terms of the relationship between the funds supplied by creditors and owners.

(2) The amount and proportion of debt in a firm's capital structure is extremely important to the creditor because of the trade-off between risk and return. Use of debt involves risk because debt carries a

fixed commitment in the form of interest charges and principal repayment. Failure to satisfy the fixed charges associated with debt will result in bankruptcy. Interpretation of the ratio if that for every dollar of owners' funds, there is a certain amount from creditors. The higher ratio, the greater the risk.

(3) For "Projected at Origination" include the effect of the pending financing on the ratio components.

d. **Loan to Value - Fair Market.**

(1) Actual at origination: This percentage is derived from the approved loan amount divided by the total value of all loan collateral using market valuation.

(2) Projected at Origination: Include loan collateral that will be obtained through the pending financing.

e. **Loan to Value - Liquidation.**

(1) Actual at origination: This percentage is derived the same way as "Loan to Value - Fair Market" except that liquidation values are used for the loan collateral instead of market valuation. The following percentages of market valuation should be used to determine liquidation value unless you can clearly establish a different value using available information:

Commercial Real Estate.......75%	Machinery & Equipment........50%
Residential Real Estate.........80%	Furniture & Fixtures..............10%
Unimproved Land................50%	Accounts Receivable..............20%
Leasehold Improvements........5%	Inventory................................20%

(2) Projected at Origination: Include collateral that will be obtained through the pending financing, using the above liquidation values.

f. **Net Realizable Value at Default.**

The net realizable value of loan collateral is the total recovery that can reasonably be expected from the sale of an asset. You should start with the above liquidation values for loan collateral, or other values that can be clearly supported by loan documentation. Outstanding senior liens should then be deducted along with taxes owed. Next, subtract anticipated sales costs plus expenses that will be incurred for care and preservation of the asset during the sale process.

4. **Is this a Piggyback Loan?**

a. Indicate by "Y" or "N" whether the loan is a "piggyback" as defined in SOP 50 10.

b. If Yes—Is the Same Lender Involved? If this is a piggyback loan, indicate by "Y" or "N" whether the participant is the same lender holding a senior lien position.

5. **If this a RE loan?**

Indicate by "Y" or "N" whether the loan purpose was real estate (e.g., a majority of the loan proceeds were used for the acquisition, construction, or refinancing of real estate to be used in the business).

6. **Is there a Change in Ownership?**

Indicate by "Y" or "N" whether the SBA financing was made in connection with a change in ownership of the business which applied for the loan.